Islam and Economic Challenge
Introduction to Islamic Economy, Banking and Finance

Farhat Khan

European Institute for Interest Free Economy

Polish Muslim Union
IP Direct Group

Presentation for Strohalm Foundation

Amersfoort 19.11.2004

Definitions I

- Dimensions of Islam

-Spiritual, social, economical, political

-Inner and external

-Horizontal (man - man), vertical (man – god)

- Origin of Islamic economy, finance and banking
- Islam vs. Muslims

Definitions II

- Maqasid Al-sharia

-falah (human well being) +hayat tayybah (good life)

= Brotherhood, socio-economic justice, balanced satisfaction of both material and spiritual life of **all human beings**

The Vision I

- Human well being is the professed objective of all societies
- **Ghazali:** the very objective of the shariah is to promote the welfare of the people, which lies in saferguarding their faith, their life, their intelect, their posterity and their wealth. Whatever ensures the saferguarding of these five serves public interest and is desirable

The Vision II

- **Ibn al Qayyim**: the basis of the shariah is wisdom and welfare of the people in this world as well as the hereafter. This welfare lies in complete justice, mercy, well – being and wisdom. Anything departs from justice to oppression, from mercy to harshness, from welfare to misery, from wisdom to folly has nothing to do with sharia

The Reality

- Poverty and ecological disaster
- Injustice and human imbalances
- Wars & violence
- Capitalism/socialism/fascism/welfare state ?
- OIC – over 1,5B Muslims
- In Europe 15M Muslims
- In the Netherlands – 800K-1.5M Muslims

Negative Results: Clash of Civilizations

- Samuel Huntington about Muslim era wars
- How to end wars and violence?
- How to end injustice?
- How to end poverty?

Positive Results:

- Exchanges of view
- Mutual cooperation
- Acceptance of critical and logical thinking
- Acceptance of principle of tawhid on individual level and justice on social level

The Islamic Response: Al Qur'an

God does not change the conditions of a people until they change their own inner selves.

Al – Qur'an: Chapter 13 verse 11

Wide Gulf: Muslim or Islamic World

Afghanistan
Albania
Algeria
Azerbaijan
Bahrain
Bangladesh
Benin
Brunei
Burkina Faso
Cameroon
Chad
Comoros
Cotê d'Ivoire
Djibouti

Egypt
Gabon
Gambia
Guinea
Guinea Bissau
Indonesia
Iran
Iraq
Jordan
Kazakhstan
Krghyz Rep.
Kuwait
Lebanon
Libya

Malaysia
Maldives
Mali
Mauritania
Morocco
Mozambique
Niger
Oman
Pakistan
Palestine
Qatar
Rep. of Togo
Saudi Arabia
Senegal

Sierra Leone
Somalia
Sudan
Suriname
Syria
Tajikistan
Tunisia
Turkmenistan
Turkey
Uganda
UAE
Uzbekistan
Yemen

Islamic Worldview and Strategy

The Worlview

- Tawhid (Divine Unity)
- Khilafah (Vicegerency)
- Adalah (Justice)

The strategy

- The Filter Mechanism
- The Right Motivation
- Socio-Economic Financial Restructing
- Role of the State

Tawhid (Divine Unity)

- The foundation and the stone of the Islamic Faith.
- There are two Arabic words that are important to know. These are *tawhid* and *shirk*. *Tawhid* means "declaring God one", while *shirk* means "associating partners with God". Thus *tawhid* is monotheism while *shirk* is polytheism or idolatry.
- Tawhid al Rububiyya.

(*Tawhid ar-rububiyya* thus means declaring that there is only One who.

Tawhid (Divine Unity) II

holds these divine functions of creating and sustaining the universe).

- Tawhid al Esma al Sifat.

(declaring God one in His names and attributes).

- Tawhid al Ibada.

(*tawhid al-ibada* means "declaring God one through our service“).

Khilafah (Vicegerency)

- Universal brotherhood

-All human beings are dependents of god and the most beloved of them before him are those who are best to his dependents

- Resources are a trust (Q: 2:229)
- Humble life style
- Human freedom

Adalah (Justice)

Establishment of justice and eradication of all forms of injustice have been stressed in the al Qur'an as the primary mission of all god's Messengares (Q: 57:25) Justice is next to piety (Q: 5:8) 200 places in the Quran against injustice

- Need fulfillment
- Respectable source of earning
- Equitable source of earning
- Growth and stability

Introduction to Financial System

- The origin of Islam and its financial system

-

- The discovery of oil and its consequences

-

- The 4 branches of the Islamic banking industry

-the internationally catalic (IDB, DMI, DBG)
-the domestically retroactive – responding to legal change (Iran)
-the domestically proactive – responding to demand (Ghamr)

-the internationally retroactive – responding to demand (Citi)

Principles of Islamic Finance

- Sharia
- Riba
- Gharar
- Zakat
- Misconception about Islamic finance

Sharia

- Regulates Islamic Banking/Finance
- Islamic Law derived from 4 sources:
  - Al Qur'an
  - Sunna
  - Ijma (the dilligent judgment of the scholars through reasoning and logic)
  - Qijas (consensus)

Riba

- Prohibition in the Al Qur'an (4 verses)
- -2.275 ex.
- Prohibition in the Sunna
- Interest = Usuary = Riba (Marocco exception)

Gharar

- An exchange in which there is an element of deception through the ignorance of the goods or price, or false description of the goods
- Gambling is the form of gharar

Zakat

- Religious tax or alms
- Literary: arab. Purification
- 2 types: Zakat al Fitr and Zakat al Maal
- Zakat al Maal – annual levy on total wealth if the total is above a certain level (2,5%)

Misconception about IF

- Islamic Finance is essentially communist in nature
- Without interest there will be no investment
- Allah permitted trading and forbade riba; the distinction between riba and trade
- There are no alternatives to interest –based investments
- There is no room for innovation and development

Islamic Finance – Banking Partnership

- Citibank
- ANZ Group
- Societe General
- Deutsche Bank / Commerzbank
- ABN Amro

The Techniques of Islamic Finance

- The role of sharia committee
- Murabah (cost plus sale)
- Musharakah /Mudaraba (partnership equity/trustee)
- Ijara (leasing)
- Qard al Hasan (loan)
- Bai Salam (purchase with deferred delivery)
- Islamic syndication

Islamic Mortgages Techniques

- MODEL A: lease with option to purchase
(Ijara wa iqtina)
- MODEL B: purchase on installments
- MODEL C: decreasing partnership (rent to own concept)

The Techniques of Islamic Finance – Profit and Loss Sharing modes (PLS)

PLS mode

- Mudaraba – Trustee Finance
- Musharaka – Equity Participation
- Muzar'ah – MDB in farming
- Musaqat- MSH in orchard keeping
- Direct Investment

Non-PLS mode

- Qard al Hasana – Beneficience loans
- Bai Muajjal – Defferded payment sales
- Bai Salam (Bai Salaf) Purchase with deferred delivery
- Ijara (Ijara wa iqtina) Leasing/Lease purchase
- Murabaha – Mark up
- Joalah – Service Charge

A Comparison Between Islamic & Conventional Banking

Features	Islamic Banking	Conventional Banking
Guarantee of the capital value: Demand deposits Investment deposits	 Yes No	 Yes Yes
Rate of return on deposits	Uncertain, not guaranteed for investment deposits. Demand deposits are never remunerated.	Certain and guaranteed
Mechanism to regulate final returns on deposits	Depending on bank performance / profits from investment	Irrespective of bank performance/profits from investment
Proft-and-loss (PLS) principle applies	Yes	No
Use of Islamic modes of financing: PLS & N-PLS modes	Yes	Not-applicable
Use of discretion by banks with regard to collateral	Generally not allowed to reduce credit risk in PLS modes. By way of exception, may be allowed to lessen moral hazard in PLS modes. Allowed	Yes, always

Two Intermediation Models

Two-tier Mudaraba

- Assets and liabilities fully integrated
- Unrestricted Mudaraba on depositors site
- Restricted Mudaraba on entrepreneurs site
- No specific reserve requirments

Two windows model

- Bank liabilities are divided into 2 windows: demand deposits and investments deposits
- 100% reserve on demand deposits
- Investment deposits used to finance risk bearing investments

Result of the Models: Stability

- Owing to the structure of their balance sheet and the use of PLS arrangements Islamic bank are better poised than conventional banks to absorb external shocks
- Socially responsible
- Ethically filtered

Islamic banks vs. Conventional Investment Companies

Operational Similarity

-they both do not guarantee either the capital value of or a return on investment deposits

Conceptual Difference

-Investment company sell their capital to the Public, while Islamic banks accept deposit from public

-Depositor do not have voting rights

-Depositors do not own any portion of the bank's equity capital

Other Issues

- Takafful – Islamic Insurance
- Equity Finance
- Project Finance
- Accounting and Auditing
- Legal aspects of IF& B

The Global Islamic Economy

- Prospect of Islamic finance
- Problems of Islamic finance

European Institute for Interest Free Economy

Goals:

- **to educate people about alternative money system(s) which implements concept of justice better then existing one.**
- **To improve Islamic banking and finance concept in Europe.**
- **To bring together interest free promoting organization from Islamic and Western world.**
- **Promoting Sustainable Development based on Interest Free Economy.**

European Institute for Interest Free Economy

Achievements:

- 5th International Conference on Islamic Economy and Finance in Bahrain.
- http://www.ipdirect.home.pl/dinar/.
- Seminars and translations on Interest Free Economy.
- Cooperation with Strohalm, Islamic Foundation and Benelux Shura.

Questions and Answers

- IP Direct Group www.ipdirect.home.pl
- EIIFE www.ipdirect.home.pl/kmp
- PMU www.ipdirect.home.pl/kmp

- Farhat Khan: islam@ipdirect.home.pl